THE CITY LIBRARY

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COMPLIANCE OFFICER BULLETIN

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Akin Gump's EU/UK Financial Regulatory Practice advises its clients (which include institutional and alternative investment managers, retail and investment banks, brokerages and senior individuals) on all aspects of the UK and EU financial services regulatory framework. The Practice has taken a leading role in advising the global financial services industry on regulatory actions, the impact of EU legislation and on commercial and securities issues that affect it. The Practice is particularly well known for its work acting for financial institutions and senior individuals who find themselves subject to investigation by regulators and exchanges.

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1. Introduction: A climate of uncertainty: FCA focus on outcomes rather than rule compliance?

The FCA has made it clear that it intends to take a more outcome-focused approach to regulation and supervision. This position was adopted following the banking crisis where it was considered that "tick box" regulation that focused on rule compliance had failed and that the FSA had not been as effective a conduct regulator as it could have been.[1]

The FCA has said:

> "We are determined to create a culture of good conduct at every level of the industry – to make markets work well and to produce a fair deal for consumers – through a more proactive, more interventionist, more creative and more judgment-based approach."[2]

> "The question is how many rules do we need as well? I instinctively believe that less is more, on the twin grounds that (A) we have made a great many rules already but they don't seem to prevent further problems arising, and (B) what starts as an attempt to provide clarity frequently ends up creating complexity."[3]

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The shift in regulatory focus to broader concepts of culture, and anticipating areas of risk rather than seeking to punish firms after the event for specific rule breaches, is to be applauded. However, the consequence is that the current regulatory environment is uncertain for financial services firms who must anticipate what outcomes the regulator expects and translate this into practice within their firms as well as ensuring compliance with the specific FCA rules. The FCA has made it clear that mere rule compliance will not be a sufficient defence should it feel that the right consumer outcome has not been achieved but, at the same time, firms cannot ignore the detailed rule requirements without risk of regulatory sanction.

As part of the outcomes-focused approach, the FCA is striving to negotiate agreements with firms to achieve swift remedies to identified problems and faster redress. While such agreements may save both firms and the regulator time and money in the short term, they do not always have the safety and rigour of being subject to scrutiny and challenge through the enforcement investigation process. Firms are left with few options when the regulator tells them they expect a particular outcome but the process by which this regulatory outcome is to be achieved is through discussion rather than through the formal handbook process.

The FCA does recognise the concern felt by the industry that the regulator's expectations are unclear:

> "And this leads me to the second point in my plan, the need for clarity of what we expect from 21st century financial services. I had thought, or at least assumed, when I first joined the FCA, that our conduct requirements were generally understood by the industry and consumers, if not always accepted as being the right ones. I quickly learned that it was not so straightforward, and in particular there was much talk of the moving of goal posts, expectation gaps and retrospective regulatory activity.
>
> Much of this was, with hindsight, sophisticated lobbying, but some reasonably founded in fact. Either way, it brought home to me the importance of a clear regulatory expectation, in ensuring that markets work well."[4]

It is difficult see how the regulator can reconcile making its expectations clear whilst still maintaining that compliance with rule requirements will not be sufficient. Firms are expected to understand and anticipate what the regulator might perceive as a shortcoming, even when compliance with rule requirements is achieved.

In this issue we discuss the outcome of the guidance on the Retail Distribution Review ("RDR"), a process instigated under the FSA which focuses on granular rule requirements; the consultation on changes to the approved person regime for banks and designated investment firms; and provide a round-up of the key enforcement cases over the last year. We also discuss recent developments in Europe and, in particular, MiFID II and revision of the Market Abuse Directive.

2. FCA scrutiny of wholesale conduct

Where previously the regulator had considered wholesale participants sophisticated enough to protect their own interests, it has now acknowledged that, following events such as the LIBOR scandal, and interest rate swap mis-selling, wholesale conduct can, and does, have an ultimate impact on retail consumers.

The FCA business plan for 2014–2015 stated its intention to place wholesale conduct under greater scrutiny than ever before.

> "In 2014/2015 we will increase the intensity with which we supervise wholesale conduct to ensure transactions between sophisticated market participants do not have a harmful impact on market integrity. Through this we will also help prevent risks from the wholesale markets causing harm to retail consumers."[5]

The regulator has said that its focus in wholesale is to look at two specific types of behaviours: those that impact the integrity of the market; and those that impact those who use the market, i.e. the investors. The FCA will no longer draw a hard line between retail and wholesale.[6]

The FCA is addressing wholesale conduct through policy development, international engagement, and firm-specific assessments of investment banks, trading firms, and asset managers and has emphasised that addressing the culture, systems and controls that govern wholesale relationships is a priority area for it.[7] Its approach is demonstrated in the recent thematic reviews, which have included review of market abuse controls within asset managers, conflicts of interest in investment banks, controls over flows of information in investment banks, trader controls around benchmarks and agency responsibilities of asset managers.

It has become part of the FCA's practice to require senior management to attest to systems and controls in place to manage conduct risks, and firms are required to demonstrate that their business models and strategy are based upon fair treatment of customers, and contribute to the integrity of the market in which the firm operates.

Wholesale conduct is also a major focus of MiFID II. Proposals that advance best execution obligations, and restrictions around the use of dealing commissions to purchase investment research are two significant areas. The FCA has said that implementation of MiFID II is a massive project and it recognises the scale of the challenge posed for the industry.[8]

Interestingly, in the course of its increased focus on wholesale conduct, amongst other things the FCA has said that it wants to understand whether wider market outcomes are being achieved "rather than if a firm is meeting individual rules".[9] Nonetheless, as noted above, it is apparent that compliance with the rules will still matter!

The FCA expects wholesale firms to ensure proper market behaviour all the way from the Board room through to the investment manager and trading desk. Nonetheless, it accepts that there is a responsibility on the regulator to be transparent, discuss issues, and to understand the reasons why a firm may conduct its business in a particular way. It has signaled that it intends to spend time with the business to understand what they do, how they do it, how they think about risk, customers and the market, and how they identify, assess and control risks in the business. The reasoning behind this is that the FCA believes that problems with retail and wholesale behaviour are the result of strategies or practices driven by and implemented by the business either from the Board, Executive Committee or in individual business lines rather than a flawed compliance or Internal Audit framework (although these are still relevant factors). This increased focus on how the business is run, rather than how it is controlled, is a fundamental change and is directly linked to the FCA's forward-looking, outcome-focused philosophy.[10]

The pressure is on wholesale firms to ensure that their systems and controls meet the FCA's requirements but also that their business plan, firm strategy, and incentive schemes are in keeping with the FCA's broader expectations as to market conduct. This requires significant cultural change within the wholesale sector. Nonetheless, if firms fail to move quickly to ensure that they stand up to regulatory focus we can expect enforcement action to follow.

3. Retail distribution review

The FCA continues to place priority on the impact of behavioural economics and how this can be used to inform consumer behaviour and inform how "real people interact with financial markets". Accordingly, where firms could have previously relied on providing disclosure with their products which would meet FCA rule requirements, the FCA is now designing policy based on how customers actually engage with financial products.[11] The FCA is confident that this approach will achieve better consumer outcomes but it accepts that "nudges and the like can be very powerful, but they are not always a practical replacement for rules. Nor are they straightforward to apply".[12]

The FCA's continued emphasis on rules and its intention to ensure that the rules in place are properly understood and applied can be seen in its recent review of the RDR, against its objectives.

The RDR was implemented in December 2012 and sought to create new rules and update the existing FCA Handbook rules to ensure investment advice was free from bias and to improve clarity for consumers in relation to investment advice and associated services. The finalised guidance stated that firms that provided retail advice to retail clients would need to classify themselves as "independent" and able to advise on all types of retail investment products or "restricted" and only able to recommended certain products. Firms also needed to be clear about their charging policies, to ensure clients were supplied with accurate information and could be sure about the type of advice being given and the cost of such advice.

Over the past year the FCA has conducted a three-part thematic review[13] (the "Review") to consider how the industry was implementing the RDR,[14] and issues such as how far firms that held themselves out as "independent" were meeting the criteria for independence,[15] and whether firms were fully disclosing their charges.[16] As part of this Review, and in response to industry demand, the FCA attempted to clarify its expectations and give examples of good and bad practices. It seemed apparent that there was some confusion within the industry as to what was required and the practical impact of the rules and the FCA sought to provide additional guidance as to its expectations.

3.1 Independence

The FCA set out the standard for independent advice as being a personal recommendation that is required to be:

i) based on a comprehensive and fair analysis of the relevant market; and

ii) unbiased and unrestricted.[17]

The FCA has said that a firm seeking to provide independent advice "should not be restricted by product provider and should objectively consider all types of retail investment products".[18] The FCA has considered the meaning of "comprehensive" and said that, from a practical perspective, this should not mean firms need to complete detailed due diligence on every product and provider in the market. Firms should carry out research on the whole market to identify solutions for a particular client and then conduct detailed due diligence on the recommended solution.[19]

During the Review, the FCA had regard to a number of "potential indicators of non-compliance"[20] that it considered a risk to firms being able to offer independent advice. For example, placing a very high proportion of business on one platform and with a limited number of providers was considered a potential indicator.

3.2 Disclosure

The FCA felt that many firms were failing to comply with the cost disclosure requirements set out in the RDR, with up to 73 per cent of firms failing to provide clients with the required generic information on their charges and/or failing to confirm specific costs to clients in a timely manner.[21]

The FCA also expressed concern about firms who offered a restricted service, but failed to make it clear that they were providing a restricted service and/or failed to provide sufficiently clear descriptions of those restrictions. The FCA published a factsheet to further clarify their requirements in the form of a list of questions for investment advisers to ask in relation to their practices.[22] The FCA is currently reviewing how firms have acted on the FCA's feedback to the RDR. The FCA has said that if firms are still failing to comply with the RDR, it will consider further regulatory action[23] and enforcement action.

The additional information provided by the FCA in this area is helpful and signals the FCA's wish to provide additional clarity and guidance where required. The FCA has acknowledged that the rules are complex and that it has been forced to clarify its rules in some areas, such as the rules on independent financial advisers using internal specialists and making data reporting less burdensome.[24]

This is in keeping with the FCA striving to be more transparent as to its expectations. It is, however, an example of the regulator implementing rules which then require detailed guidance as to how they are to be given effect. Given the length of time since the RDR was implemented, and the FCA's focus on consumer outcomes, we can expect the FCA to have little patience with firms it considers are falling short, especially if this leads to consumer detriment.[25]

4. Strengthening accountability of individuals in banking

In July 2014 the FCA and PRA (the "Regulators") issued a joint consultation paper[26] (the "Consultation Paper") on strengthening the accountability of individuals in the banking sector. The new regime will apply to "relevant firms". Relevant firms are UK banks, building societies, credit unions and PRA-designated investment firms. The proposals were developed following the passage of the Banking Reform Act[27] and the recommendations made by the Parliamentary Commission on Banking Standards which had been very critical of the existing Approved Persons Regime.[28] Martin Wheatley, CEO of the FCA, said that the:

> "... consultations mark a fundamental change in the regulators' ability to hold individuals to account, which is what the public expects of us. It will also build on the cultural change we are beginning to see in the boardrooms of firms across the country."[29]

4.1 The Senior Managers Regime

The Senior Managers Regime will replace the current Significant Influence Function ("SIF") regime[30] with the concept of Senior Management Functions ("SMF") for relevant firms.[31]

Those individuals deemed to be exercising SMFs will include the heads of key business areas meeting certain quantitative criteria, those individuals in the parent or group companies that exercise significant control over decisions, and other individuals who have overall responsibility for key functions, or identified risks (these are referred to as Significant Responsibility SMFs).

The SMFs are intended to clearly allocate responsibilities to senior managers and promote greater accountability. All applications submitted as part of the SMF approval process will need to be accompanied by a "Statement of Responsibilities", which will be a statement that sets out the business areas each senior manager is responsible for. An updated statement will also need to be submitted whenever there is a "significant change" in the responsibilities of a senior manager.

The Regulators also intend to introduce "Responsibilities Maps". Further guidance is to be issued on these, but the expectation is that these maps will be a single document that describes the management and governance arrangements of a firm, aiming to avoid any gaps in accountability.

The statutory burden is now on senior managers to show that they took "reasonable steps" to prevent or stop regulatory breaches by the firm and as with criminal prosecutions, the Regulators will consider what constitutes "reasonable steps" on a case-by-case basis.[32]

4.2 The Certification Regime

Individuals performing a role relating to a relevant firm's regulated activities (which is not a SMF) but who may pose a risk of significant harm to the firm or its customers must be certified by the firm (rather than the regulators) as fit and proper. The firm must also undertake annual reviews of the relevant individuals to renew the certificates and ensure ongoing compliance.

4.3 The Conduct Rules

New Conduct Rules will replace the existing Code of Practice for Approved Persons ("APER") for those firms categorised as relevant firms. The FCA will apply these Conduct Rules to all staff and employees of relevant firms, with the exception of those explicitly exempted by the FCA on the grounds that their role would be fundamentally the same if they worked in a non-financial firm, such as receptionists, post room staff and security guards.[33] The PRA intends to apply the Conduct Rules solely to those individuals approved as senior managers or certified under the Certification Regime.

The Conduct Rules are high-level rules, based on the existing APER rules and general principles, reflecting the broad range of employees that will be subject to them. Firms will have an obligation to train employees on the Conduct Rules and to inform the Regulators when they become aware or suspect that a person has breached any of the Conduct Rules.

Policy statements setting out the final rules are expected in early 2015.

Industry reaction to the proposals has been negative. The general sense is that the Regulators have rushed through these proposals and have not appreciated what a huge task it will be for the relevant firms to implement them. Whole teams will need to be set up within firms to deal with the certification process and application and supervision of the conduct rules. There has also been criticism from outside the industry that the reforms do not go far enough. The question must be asked as to the regulators' confidence in leaving banks to undertake a degree of self-monitoring (albeit with regulatory consequences when they fall short) when they have been the subject of such criticism as to conduct.

While we would hope the Regulators will take industry concerns and feedback into account, the pressure on the Regulators to push these regimes through may mean that rules are implemented that may not achieve the outcomes that are sought. Firms that do not fall within the scope of these changes should still monitor them carefully as there is a real possibility that the FCA may seek to extend the scope of this regime beyond banks and designated investment firms. Given the current push towards requiring attestations from senior management, it is apparent that the regulatory appetite for continuing to hold individuals to account continues.

5. Continuing credible deterrence

Although the emphasis of the FCA could be said to have shifted to pre-emptive action and outcome-focused regulation, there is no question that enforcement remains a key priority for the FCA and an important part of its regulatory tool kit. Significant fines imposed for breaches of money laundering regulations and CASS rule breaches reinforce the fact that the FCA has not lost interest in these areas and firms are still found to be falling short.

The fine of £30 million imposed on HomeServe (discussed below) indicates that the FCA will take rigorous action and seek ever increasing fines where it feels that firms are not getting the message that mis-selling and poor communication with retail customers will not be tolerated.

The fines imposed in relation to FX fixing (agreed by way of settlement) are the largest yet, and the FCA's action in relation to an area that was not regulated activity could be seen as a precursor to its approach in relation to the extension of the conduct rules to persons working within banks.

5.1 Money laundering

Standard Bank PLC

The FCA fined Standard Bank PLC ("Standard Bank") (the UK subsidiary of Standard Bank Group, South Africa's largest banking group) £7,640,400[34] for its failure to comply with Regulation 20(1) of the Money Laundering Regulations 2007, and other relevant Regulations.[35] This was the first anti-money laundering case the FCA (or its predecessor, the Financial Services Authority) has brought that has focused on commercial banking activity.

Regulation 20(1) requires that a relevant person must establish and maintain appropriate and risk-sensitive policies and procedures in relation to a number of criteria. The FCA found that between December 15, 2007 and July 20, 2011 Standard Bank had failed to comply with Regulation 20(1) as it had not taken reasonable care to ensure that all aspects of its anti-money laundering policies and procedures were applied appropriately and consistently to its corporate customers connected to politically exposed persons ("PEPs"). Standard Bank had also failed to follow the guidance from the Joint Money Laundering Steering Group ("JMLSG") which provides that a corporate customer linked to a PEP should be considered a higher risk and that enhanced due diligence measures should be applied in such situations. During the relevant period considered by the FCA, Standard Bank had 5,339 corporate customers with 282 of these linked to PEPs.

The FCA said that Standard Bank did not consistently carry out adequate enhanced due diligence on corporate customers with PEP links before establishing business relationships with them, or demonstrate that all relevant risk factors had been taken into account when deciding the money laundering risk of each customer. Standard Bank also failed to appropriately monitor and review its due diligence on existing customers to ensure that its risk assessments remained up to date.

These failings were considered by the FCA to be particularly serious as: (i) Standard Bank provided services to a significant number of corporate customers originating from or operating in high-risk jurisdictions; (ii) Standard Bank had identified issues with respect to its ongoing monitoring of customer risk but had failed to resolve these issues; and (iii) the FCA has previously brought actions against a number of firms for anti-money laundering failings and emphasised to the industry the importance of complying with the anti-money laundering requirements.

Tracey McDermott, director of enforcement and financial crime at the FCA, said:

> "One of the FCA's objectives is to protect and enhance the integrity of the UK financial system. Banks are in the front line in the fight against money laundering. If they accept business from high-risk customers they must have effective systems, controls and practices in place to manage that risk. Standard Bank clearly failed in this respect."[36]

It is apparent from the action taken that the FCA continues to take compliance with anti-money laundering seriously and that it will take action against firms whose systems and controls are weak in this area.

5.2 Treating customers fairly

State Street UK

On January 30, 2014, the FCA fined State Street Bank Europe Ltd and State Street Global Markets International Ltd (together, "State Street UK") £22,885,000[37] for breach of Principles 6 (customers' interests—treating customers fairly), 7 (communications with clients), and 3 (management and control) of the FCA's Principles for Businesses (the "Principles") during the period January 1, 2010 to September 30, 2011 (the "Relevant Period"). One of the investment services State Street UK offers is transition management, the carrying out of major structural changes to asset portfolios on behalf of clients with the intention of managing risk and increasing returns.

The FCA found that during the Relevant Period, State Street UK had failed to treat its customers fairly by allowing a culture to predominate in the UK transition management business that it said prioritised revenue generation over client interests and followed a deliberate strategy to charge substantial mark-ups on certain transactions. Such mark-ups were deliberately not agreed with clients or disclosed to them, constituting a breach of Principle 7.

The FCA considered these breaches particularly serious as: (1) overcharging generated over 25 per cent of the total revenue earned by State Street UK's transition management business during the relevant period, despite occurring on only 3.5 per cent of the transitions; (2) in the relevant transitions, State Street UK had falsely held itself out as complying with the industry best-practice code for transition managers ("the T-Charter"), State Street UK either acted as agent, holding itself out as being a trusted adviser, or fiduciary, thereby breaching a position of trust; (3) State Street UK's clients included firms who held pension funds and savings for retail customers; therefore State Street UK's actions in the wholesale market had caused a serious risk of detriment to the retail market; and (4) State Street UK had such serious weaknesses in its controls and procedures that senior management and Compliance remained unaware of the issues until the overcharging was highlighted by a client.

The action taken against State Street is an example of the FCA emphasising not just the importance of the Principles but also its assessment of the culture within the firm. It is an example of the scrutiny the FCA is placing on wholesale firms as Tracey McDermott said the case was:

> "... another example of a firm that has acted with complete disregard for the interests of its customers. State Street UK allowed a culture to develop in the UK [transition management] business which

> prioritised revenue generation over the interests of its customers. State Street UK's significant failings in culture and controls allowed deliberate overcharging to take place and to continue undetected. Their conduct has fallen far short of our expectations. Firms should be in no doubt that the spotlight will remain on wholesale conduct."[38]

HomeServe

On February 12, 2014, HomeServe Membership Ltd ("HomeServe") was fined £30,647,400 for breaching Principles 3 (management and control), 6 (customers interests—treating customers fairly) and 7 (communications with clients) of the Principles. HomeServe is an insurance intermediary that advises on and sells home emergency and repairs insurance cover. The penalty imposed was the largest retail fine issued by the FCA at the time of writing.

The FCA found that HomeServe had serious, systemic and long-running failings, extending across many key aspects of its business. In particular, between January 2005 and October 2011 it was found to have mis-sold insurance policies, failed to give adequate attention to investigating complaints and its senior management fostered what was described by the FCA as a "profit-driven" culture at the expense of its customers.

The FCA considered that HomeServe had failed to foster a culture that focused on compliance and fair treatment of customers. The board and senior management of the firm were said to have demonstrated a lack of attention to, and knowledge of, compliance and regulatory issues. The remuneration structure in place for the sales teams and complaint handling teams was considered to have focused on increasing volumes of products sold and complaints were closed without due consideration of the clients' interests.

HomeServe had, at the time of the FCA's fine, paid out £12.9 million by way of redress to affected customers and was expected to pay out a total of £16.8 million. The FCA described the failings as particularly serious given that many of HomeServe's customers were of retirement age and therefore more vulnerable.

Tracey McDermott used the case as an example to demonstrate the wider aims of the FCA and again place emphasis on the importance of firm culture and management responsibility:

> "Firms must put the interests of customers at the heart of their business if we are to restore trust and confidence in financial services. True change in the culture within the financial services industry will only be achieved when firms and their management accept and deliver on their responsibility to ensure that customers are treated fairly."[39]

FXCM UK

The FCA fined Forex Capital Markets Ltd ("FXCM Ltd") and FXCM Securities Ltd (together "FXCM UK") a total of £4,000,000 for allowing its US-based FXCM Group to withhold profits worth approximately £6,000,000 that should have been passed onto FXCM UK's clients.[40] FXCM UK was also held to have failed to inform the FCA that the US authorities were looking at another part of the FXCM Group for the same misconduct.[41]

FXCM Ltd's revenue is largely generated by trading in rolling spot forex trades. It was deemed to have breached Principle 6 (customers' interests—treating customers fairly) by withholding profits it gained from favourable price movements from customers in favour of retaining them for the larger FXCM Group, whilst passing on any losses to the customers (a practice known as asymmetric price slippage). While the impact on individual trades was usually limited and it was accepted that FXCM Ltd itself did not retain any gains from price improvements the FCA took a serious approach to this behaviour, considering it to be a systematic and prolonged unfairness in trading terms that reduced the customers' ability to profit from trading in rolling spot forex trades. FXCM UK was also said to have failed to check that its order execution systems were effective and whether its order execution policies complied with the FCA's rules on best execution. These rules require firms to take reasonable steps to secure the best possible deal for their clients.

The FCA held that FXCM UK had breached Principle 11 by failing to disclose to the FCA that in 2010 the US regulatory authorities had started investigating another FXCM Group company in relation to their use of asymmetric pricing, and that subsequently the FXCM Group company had decided to settle with the US authorities and pay redress to US customers affected.

David Lawton, the FCA's director of markets, noted the broad scope of the FCA's powers to monitor and enforce its policies:

> "When consumers lose out because of poor conduct it undermines confidence in the integrity of our markets. The FCA will use all the tools at its disposal – supervision, rule-making and enforcement – to ensure that firms do not exploit conflicts of interest or the trust placed in them by clients."[42]

5.3 Failures in communication with customers

Santander UK

On March 24, 2014, Santander UK plc ("Santander") was fined £12,377,800 by the FCA for failing to pay due regard to communicating information to clients that was clear, fair and not misleading (Principle 7)[43] and failing to ensure the suitability of its advice for customers entitled to rely upon its judgment (Principle 9).

Santander's provision of investment advice became subject to examination by the FCA following the FCA's mystery shopping review of retail investment advice and during the course of its Wealth Management thematic review.

The FCA said its investigation had found that Santander had:

- failed to ensure its advisers were fully getting to grips with customers' personal circumstances before making a recommendation, including understanding their risk appetite;
- failed to ensure that customers investing were given clear and not misleading information about its products and services;
- for Premium Investments, failed to carry out regular ongoing checks to ensure that the investment was still meeting customer needs;
- failed to make sure new advisers were properly trained before being allowed to give investment advice; and
- failed to properly monitor the quality of investment advice which meant that, where poor advice was given, it was not always picked up.

Santander, in agreement with the FCA, was to conduct a customer contact exercise and pay redress where necessary. It was anticipated that consumer losses would be minimal. Notably, when the FSA first put its concerns to Santander in late 2012 the firm immediately decided to stop giving financial advice in branches to prevent further problems occurring.

Tracey McDermott considered the case of Santander in the context of the wider financial markets:

> "Customers trusted Santander to help them manage their money wisely, but it failed to live up to that responsibility. If trust in financial services is going to be restored, which it must be, then customers need to be confident that those advising them understand, and are driven by, what they need. Santander let its customers down badly."[44]

Invesco Perpetual

On April 24, 2014, the FCA imposed a penalty of £18,643,000 on Invesco Asset Management Ltd ("IAML") and Invesco Fund Managers Ltd (together "Invesco Perpetual"). Invesco Perpetual is the largest retail investment manager in the UK. The FCA imposed the penalty for breaches of Principles 3 (management and control) and 7 (communications with clients), plus associated rules in the Collective Investment Schemes Sourcebook ("COLL").

Invesco Perpetual was found to have failed to comply with investment restrictions (under COLL 5.2) which are intended to protect consumers by limiting their exposure to risk. Some of the Invesco Perpetual funds suffered losses in connection with these breaches of investment limits and the funds were reimbursed nearly £5 million. In addition, Investo Perpetual did not clearly inform investors or explain the associated risks of its use of derivatives which introduced leverage into the funds, although the firm was allowed to use derivatives in this way.[45]

The FCA considered that Invesco Perpetual had failed to invest adequately in the systems and controls around its front office in that it failed to put in place adequate systems and controls to ensure that it recorded trades in all fixed income funds on a timely basis. It was also said to have failed to put in place adequate controls to ensure that fund managers allocated partially executed aggregated trades fairly in respect of all fixed income funds.[46] Invesco Perpetual acted quickly to improve its systems and controls and to remediate the issues identified by the FCA.

In the Final Notice the FCA stated that it views "investment restrictions as a very important safeguard for consumer protection". Following the publication of the Final Notice the FCA commented on the case and reinforced their commitment to identifying potential problems before they become too serious:

> "As a forward looking regulator the FCA takes action where we see risks to consumers, not just after they suffer losses. In this case investors of all sizes trusted Invesco Perpetual to manage their money. They signed up for a certain level of risk but we found Invesco Perpetual's actions were at odds with investors' reasonable expectations."[47]

Alberto Micalizzi

In March 2014, the Upper Tribunal upheld the FCA decision to fine and ban Alberto Micalizzi for failing to act with integrity while CEO of Dynamic Decisions Capital Management Ltd ("DDCM").[48] Mr Micalizzi's approval to carry out controlled functions was also withdrawn and he was prohibited from performing any function in relation to regulated activities.

A fund managed by DDCM suffered huge losses at the end of 2008, losing up to 85 per cent of its net asset value. Mr Micalizzi was said to have failed to inform investors of this loss and continued to falsely update them with news of fund profits. Mr Micalizzi was also said to have attempted to conceal the losses by using the fund to invest in sham bonds not backed by any genuine commodity.

The Upper Tribunal agreed with the FSA that a total prohibition was necessary as Mr Micalizzi was found to have been dishonest and lacked integrity. He was therefore not a fit and proper person to carry out controlled functions. The penalty of £2,700,000[49] was imposed on Mr Micalizzi even though he was balance-sheet insolvent. The Upper Tribunal considered the purpose of a penalty is "not just to penalise misconduct; it is also to deter others from engaging in similar conduct".[50]

5.4 Wholesale conduct

Barclays–London Gold Fixing

On May 23, 2014, the FCA fined Barclays Bank PLC ("Barclays") £26,033,500 for failing to adequately manage conflicts of interest (Principle 8) between itself and its customers as well as systems and controls failings (Principle 3) in relation to the Gold Fixing.

The weaknesses in Barclays systems and controls were said to have enabled Daniel Plunkett, as a trader on the precious metals desk, to seek to influence the gold fixing on one day and profit at a customer's expense. Barclays later compensated the customer in full. Daniel Plunkett was separately fined £95,000 and banned from performing any function in relation to regulated activities for breaches of the Approved Persons Statements of Principle 1 (acting with integrity) and 3 (observing proper standard of market conduct).

The failure of Barclays to create or implement adequate policies or procedures to properly manage their traders' participation in the Gold Fixing, provide adequate specific training to precious metals desk staff in relation to their participation in the Gold Fixing and create systems and reports that allowed for adequate monitoring of traders' activity in connection with the Gold Fixing were deemed to be breaches of systems and controls under Principle 3. Barclays was said to have breached Principle 8 (conflicts of interest) by failing to adequately manage the inherent conflict of interest that existed from Barclays participating in the Gold Fixing and contributing to the price fixed during the Gold Fixing while at the same time also selling to customers options products that referenced and were dependent on the price of gold fixed in the gold fixing. This was said to lead to risk of inappropriate conduct by Barclays traders participating in the gold fixing.

Tracey McDermott reiterated the FCA's continued focus on the conduct of wholesale institutions and issued a warning to approved persons noting that they will be held accountable for their actions:

> "A firm's lack of controls and a trader's disregard for a customer's interests have allowed the financial services industry's reputation to be sullied again. Plunkett has paid a heavy price for putting his own interests above the integrity of the market and Barclays' customer. Traders who might be tempted to exploit their clients for a quick buck should be in no doubt — such behaviour will cost you your reputation and your livelihood.
>
> Barclays' failure to identify, and manage the risks in its business was extremely disappointing. Plunkett's actions came the day after the publication of our LIBOR and EURIBOR action against Barclays. The investigation and outcome in that case meant that the firm, and Plunkett, were clearly on notice of the potential for conflicts of interests around benchmarks.
>
> We expect all firms to look hard at their reference rate and benchmark operations to ensure this type of behaviour isn't being replicated. Firms should be in no doubt that the spotlight will remain on wholesale conduct and we will hold them to account if they fail to meet our standards."[51]

Lloyds

On July 28, 2014, the FCA fined Lloyds Bank Plc and Bank of Scotland Plc (together "Lloyds") £105,000,000 for misconduct in relation to the Special Liquidity Scheme ("SLS"), the Repo Rate benchmark and LIBOR. The FCA said that Lloyds had breached Principle 5 by failing to observe proper standards of market conduct; they also felt that this misconduct had been exacerbated by Lloyds' failure to maintain adequate systems and controls to organise and monitor its affairs, in breach of Principle 3.

The larger portion of the fine (£70,000,000) related to attempts to manipulate the fees payable to the Bank of England for the firms' participation in the SLS, a taxpayer-backed government scheme designed to support the UK's banks during the financial crisis. The Repo Rate benchmark was manipulated in order to reduce the firms' SLS fees which the FCA said was misconduct of a type that had not been seen in previous LIBOR cases.

In the Final Notice the FCA said that the firms had sought to avoid paying the Bank of England the fees properly due to it and risked causing significant harm to other market participants. The FCA said that the Repo Rate and LIBOR submissions were manipulated on numerous occasions and that the manipulation was condoned by a number of managers.

This penalty represents the seventh LIBOR-related fine imposed by the FCA. In her comment on the case, Tracey McDermott indicated that firms should be looking to recent enforcement cases for guidance and should reflect on the implications of previous cases on their businesses:

> "The firms were a significant beneficiary of financial assistance from the Bank of England through SLS. Colluding to benefit the firms at the expense, ultimately, of the UK taxpayer was unacceptable. This falls well short of the standards the FCA and the market is entitled to expect from regulated firms.
>
> The abuse of the SLS is a novel feature of this case, but the underlying conduct and the underlying failings — to identify, mitigate and monitor for obvious risks — are not new. If trust in financial services is to be restored then market participants need to ensure they are learning the lessons from, and avoiding the mistakes of, their peers. Our enforcement actions are an important source of information to help them do this."[52]

5.5 FX

Five banks fined

On November 11, 2014, the FCA imposed fines totalling £1.1 billion on five banks (Citibank NA, HSBC Bank Plc, JPMorgan Chase Bank NA, The Royal Bank of Scotland Plc and UBS AG) for failing to control business practices in their G10 spot foreign exchange ("FX") trading operations.

The FCA said that the G10 Spot FX market is a systemically important financial market. The failings were based on ineffective controls within the banks that were said to have allowed the FX traders to put their banks' interests ahead of those of their clients, other market participants and the wider UK financial system. The banks were said to have failed to manage obvious risks around confidentiality, conflicts of interest, and trading conduct.

The traders were said to have behaved unacceptably by sharing information about clients' activities which they had been expected to keep confidential and attempted to manipulate G10 spot FX currency rates, including in collusion with traders at other firms, in a way that could have disadvantaged those clients and the market.

The fines are the largest ever imposed by the FCA and this was the first time the FCA had pursued a settlement with a group of banks in this way. The FCA noted that although improvements had been made in the industry since LIBOR, banks had failed to take adequate action to address the underlying root causes of the failings in that business. It is clear that the FCA's expectation is for firms to identify, assess, and manage appropriately the risks that their businesses pose to the markets in which they operate and to preserve market integrity, whether or not those markets are regulated. Although there are no specific rules governing the unregulated spot FX market, the FCA considered that the importance of managing risks in this type of business was recognised in industry codes.

The FCA said:

> "Firms could have been in no doubt, especially after LIBOR, that failing to take steps to tackle the consequences of a free for all culture on their trading floors was unacceptable. This is not about having armies of compliance staff ticking boxes. It is about firms understanding, and managing, the risks their conduct might pose to markets. Where problems are identified we expect firms to deal with those quickly, decisively and effectively and to make sure they apply the lessons across their business. If they fail to do so they will continue to face significant regulatory and reputational costs."[53]

5.6 Custody assets

Barclays

On September 23, 2014, the FCA imposed a penalty of £37,745,000 on Barclays Bank Plc ("Barclays") for failing to take reasonable care to properly protect client custody assets worth £16.5 billion[54] in breach of Principle 3 (management and control) and Principle 10 (clients assets). This is the largest fine issued to date by the FCA for client asset breaches.

The breaches took place between November 1, 2007 and January 24, 2012 and occurred within Barclays' Investment Banking Division. No customers of Barclays' other business operations were impacted by the failings. The breaches were said to have arisen from weaknesses in systems and controls and a historical focus on business lines and products traded, rather than giving adequate consideration to which legal entity was conducting the business.

This was another situation where the FCA felt that the firm should have learnt and reacted to earlier enforcement actions and previous FCA publications. In the Final Notice the FCA made the point that it had "repeatedly stressed in its publications, including Final Notices, the importance of protecting clients' safe custody assets and complying with the CASS Rules".

In her commentary on the case Tracey McDermott, as director of enforcement at the FCA, reinforced this point and emphasised the lack of tolerance in the FCA for firms failing to be aware of, or responding to, the FCA's enforcement actions:

> "Barclays failed to apply the lessons from our previous enforcement actions, numerous industry-wide warnings, and exposed its clients to unnecessary risk. All firms should be clear after Lehman that there is no excuse for failing to safeguard client assets."[55]

5.7 Market abuse

Ian Hannam

On July 17, 2014, following the decision of the Upper Tribunal,[56] the FCA issued a final notice against Ian Charles Hannam imposing a financial penalty of £450,000 for two counts of market abuse involving the improper disclosure of inside information.

Ian Hannam was, at the time of these disclosures, Global Co-Head of UK Capital Markets at JPMorgan Cazenove. Mr Hannam disclosed information in two emails sent by him or on his behalf concerning one of his clients, Heritage Oil Plc. The FCA and Upper Tribunal held that the information disclosed was inside information that was not disclosed in the proper course of Mr Hannam's employment, profession or duties under s.118(3) of the FSMA. Mr Hannam's integrity and honesty were not in question and a prohibition order was not sought.

The Upper Tribunal confirmed that the standard of proof in market abuses cases is the civil standard, meaning that the FCA had to prove that Mr Hannam had committed market abuse on a balance of probabilities. The Upper Tribunal also considered the meaning of "information" under s.118C(2) of the FSMA.[57] It found that information in relation to past or current events did not need to be wholly accurate and that information in respect of future events needed to have a "realistic prospect" of occurring to be inside information. What constituted a "realistic prospect" was not given in any numerical sense but the information must not be fanciful. The Upper Tribunal also said that to be "precise" information did not need to show the extent that the price might change, or allow an investor to know with confidence the type of movement, but it must indicate the direction of movement in price that would occur if the information was made public.

The Upper Tribunal found that Mr Hannam was unable to rely on the statutory defence that he believed, on reasonable grounds, his behaviour did not fall within market abuse.[58] The FCA's comment on the case, made by Tracey McDermott, warned against the "casual" disclosure of sensitive information:

> "This has been a long and complex case but the Tribunal's substantial judgment is a landmark. It should leave market participants in no doubt that casual and uncontrolled distribution of inside information is not acceptable in today's markets. Controlling the flow of inside information is a key way of preventing market abuse and we would urge all market participants to pay close attention to the judgment."[59]

Mark Stevenson

On March 20, 2014, the FCA imposed a penalty of £662,700[60] on Mark Stevenson, an experienced bond trader, for breaching rules on market abuse[61] by manipulating the UK government gilt market. Mr Stevenson was also banned from performing any function in relation to a regulated activity. The FCA found that Mr Stevenson had traded in an attempt to artificially raise gilt prices so that he could sell a bond he held back to the Bank of England for a greater profit during quantitative easing. Mr Stevenson's trading was identified by the Bank of England as irregular and they refused to accept the offers in that gilt during quantitative easing, but had they accepted, Mr Stevenson would have apparently accounted for 70 per cent of the amount (£1.7 billion) allocated to quantitative easing on that day.

The FCA said it considered this case of market abuse particularly serious as it involved a very experienced trader trying to take advantage of quantitative easing, which meant any losses would have to be picked up by the government and taxpayers. Tracey McDermott made the following comment, holding Mr Stevenson out as an example:

> "Stevenson's abuse took advantage of a policy designed to boost the economy with no regard for the potential consequences for other market participants and, ultimately, for UK tax payers. He has paid a heavy price for his actions.
>
> Fair dealing is at the heart of market integrity. This case sends a clear message about how seriously the FCA views attempts to manipulate the market."[62]

5.8 Third party rights

Achilles Macris

In October 2013 Achilles Macris made a reference to the Upper Tribunal based on the question as to whether he should have had the right to make representations on issues raised in a Decision Notice published on September 18, 2013 against JPMorgan Chase Bank N.A. (the "Decision Notice"). The Decision Notice was issued in relation to the "London Whale" trades. At the time of these trades Mr Macris held a role in the management structure of the portfolio that suffered the losses, with the job title of International Chief Investment Officer.

The basis on which Mr Macris referred his matter to the Upper Tribunal was under s.393(11) of the FSMA. Section 393 gives third parties certain rights in relation to notices issued by the FCA against another person, and specifically requires that a third party who is identified in a decision notice, and where the notice is prejudicial to the third party, must be given a copy of the notice so that they have the opportunity to challenge any opinion expressed by the regulator in relation to him.[63] Mr Macris was not given a copy of the Decision Notice as the FCA took the view that the Decision Notice did not identify him.

The Decision Notice referred to "CIO London management", which was not a term that related to any particular body within JPMorgan, and Mr Macris contended that this term was intentionally designed to refer to him, although the FCA denied this was the case. The Upper Tribunal found that "the individual identified in the Final Notice as CIO London management cannot be anyone other than Mr Macris and the preliminary issue is decided in his favour".[64]

The FCA issued a statement on April 11, 2014 stating that it was seeking permission to appeal the decision.

6. European legislation

Directive 2004/39/EC of the European Parliament and of the Council on Markets in Financial Instruments ("MiFID"), which came into force on November 1, 2007 and which established the framework for the regulation of financial markets and securities across the European Union, has now been revised by a package of legislative reforms and amendments ("MiFID II"). The MiFID II reforms are set out in a new directive[65] and a new regulation[66] that were published in the Official Journal of the EU on June 12, 2014.

Member States are required to transpose the MiFID II directive into their national legislation by July 3, 2016, with such national rules required to come into effect by January 3, 2017, whilst the MiFID II regulation is to come into effect on January 3, 2017.

Although 2017 may seem a long way off, firms operating in the financial services sector need to be mindful of the changes that will be brought about by the new legislation and start acting now to ensure they are ready to position their businesses to operate effectively in the new regime

Some of the key changes that will be brought in are in relation to the following:

6.1 Commodities

Emission allowances ("EUAs") will become financial instruments for the purposes of MiFID II. Spot EUAs will not be in scope of the various EMIR obligations but derivatives on EUAs will continue to be.

The types of physically settled commodity derivatives covered in s.C(6) of Annex 1 to the MiFID will be extended to those traded on an organised trading facility ("OTF"). There is a carve-out for wholesale energy products (as defined in art.2(4) of the Regulation on Energy Market Integrity and Transparency ("REMIT")) that are traded on an OTF and which must be physically settled. Such REMIT contracts will not be derivatives for the purposes of the European Market Infrastructure Regulation ("EMIR") either.

Under the MiFID many entities trading commodity derivatives are able to rely on exemptions to avoid the need for authorisation as an investment firm. MiFID II will restrict those exemptions and will have significant impact on firms that currently rely on them.

Firms will no longer be able to rely on the exemption (dealing on own account in art.2(1)(d) of the MiFID) in relation to commodity derivatives, EUAs, or derivatives on EUAs.

The ancillary activity exemption is amended. It will only apply to commodity derivatives, EUAs or derivatives on EUAs and will only be available in limited circumstances to firms.

The commodity dealer exemption (art.2(1)(k)) of the MiFID) is not included in MiFID II.

MiFID II has a new exemption for operations with compliance obligations under the Emissions Trading Directive where, when dealing in EUAs, such persons do not execute client orders or provide any investment services or perform any investment activities other than dealing on own account, provided they do not apply a high-frequency algorithmic trading technique. There are also exemptions for electricity and gas transmission system operators.

MiFID II and MiFIR impose a number of key changes to reduce systemic risk, avoid disorderly trading and reduce speculative activity in commodity derivatives markets through the imposition of new position limits and management powers by trading venues and National Competent Authorities and the grant of additional intervention powers to the ESMA.

MiFID II introduces position reporting for commodity derivatives, EUAs and derivatives of such.

MiFIR provides the ESMA with position management powers allowing it to request all relevant information from any person regarding the size and purpose of a position or exposure entered into via a derivative. The ESMA can then require such persons to reduce the size of, or to eliminate their position or exposure, or as a last resort to limit the ability of a person from entering into a commodity derivative.

6.2 Trading venues and market infrastructure

MiFID II and the MiFIR create a new category of trading venue, this being the OTF. It will only relate to bonds, structured finance products, emission allowances, or derivatives. Operators of OTFs will need to be licensed as investment firms. The execution of orders on an OTF will be carried out on a discretionary basis. Certain restrictions will be applied to OTF operator business.

All types of trading venue will be subject to enhanced and identical surveillance requirements for monitoring for compliance with their rules and monitoring of orders, cancellations and transactions undertaken in order to identify breaches, disorderly trading and market abuse.

All trading venues will have to have effective systems to achieve functionality requirements and have capacity to ensure orderly trading under severe stress.

6.3 Transparency and transaction reporting

The new transparency and transaction reporting obligations in the MiFIR will apply to all three types of trading venue, although these will be designed to apply to take into account different types of instrument and different types of trading. Transaction reporting requirements will also be extended to financial instruments traded on an OTF.

MiFID II and the MiFIR will strengthen transparency and reporting obligations including where trading takes place OTC.

The obligations on investment firms that execute transactions to report them to the relevant NCA increase in scope and prescription under the MiFIR.

6.4 Algorithmic trading

MiFID II introduces closer regulation and monitoring of algorithmic trading imposing new requirements on algorithmic traders and the trading venues on which they trade.

6.5 Conduct of business

Where previously the requirement that communications to clients to be fair, clear, and not misleading only applied to retail clients, MiFID II extends this obligation to eligible counterparties.

MiFID II introduces the concept of the provision of investment advice on "an independent basis".

MiFID II creates a complete ban on inducements being received in certain circumstances. Firms providing investment advice on an independent basis or portfolio management will, in most circumstances, be prohibited from retaining any fees, commission, monetary, or non-monetary benefits received from third parties. Such benefits can be received and passed on to clients but cannot be retained by firms.

The MiFIR introduces formal product intervention powers at both the domestic and EU level.

MiFID II introduces a new EU-wide produce governance regime which applies to the product development and sales process.

MiFID II provides for more onerous obligations on investment firms to determine suitability (including of bundled packages of products).

MiFID II introduces organisation requirements which require firms to record telephone conversations or electronic communications when they receive and transmit orders, execute orders on behalf of clients and deal on their own account.

6.6 Corporate governance

MiFID II incorporates the corporate governance requirements within the CRD IV which are currently applicable to banks and certain investment firms. This effectively broadens these requirements across all investment firms.

MiFID II introduces a new requirement that the management body must define, approve, and oversee a remuneration policy of persons involved in the provision of services to clients which must aim to encourage responsible business conduct by the firm, ensure the fair treatment of clients and avoid conflicts of interest.

The changes brought in by MiFID II are far reaching and will have real impact on firms. It is advisable for firms to start engaging with these changes sooner rather than later in relation to their business models and systems and controls as putting these requirements into effect could take some time. It will require significant management engagement and potentially cultural change within firms.

7. Dealing commission

The FCA's rules and guidance on the use of dealing commission ("Dealing Commission Rules") are set out in Chapter 11.6 of the FCA's Conduct of Business Sourcebook ("COBS") and supplement the general restriction on the ability of FCA-regulated firms to accept incentives from third parties in connection with client business.[67]

The Dealing Commission Rules apply to the execution of client orders relating to shares or share-related instruments.[68]

Pursuant to the general restriction on incentives,[69] when executing client orders through a broker and passing on the broker's charges to its client, a firm must not accept any good or service in addition to the execution of its client orders if it is offered that good or service in return for the order execution charges.

An exemption from the general restriction above is available if:

- the firm is satisfied, on reasonable grounds, that the relevant good or service will reasonably assist it in providing services to its client (whose orders it is executing);
- the firm's receipt of such good or service does not, and is unlikely to, impair compliance with its duty to act in the best interests of its client; and
- the relevant good or service either: (i) is directly related to the execution of trades on behalf of the client;[70] or (ii) amounts to the provision of substantive research.[71]

The FCA will generally consider "substantive research" to be capable of adding value to the investment or trading decision by providing new, informative insights, represent original thought, have intellectual rigour, and present the investment manager with meaningful conclusions based on analysis or manipulation of data. Not all material that amounts to investment research will constitute substantive research for the purposes of the Dealing Commission Rules.

Where a firm receives research from brokers that comprises both substantive research and non-substantive research, it will need to disaggregate cost of the substantive and non-substantive elements, and only pass on the charges for those elements that amount to the provision of substantive research.[72]

7.1 Changes to be introduced by the FCA Discussion Paper

The FCA issued a discussion paper ("DP") on the use of dealing commission in July 2014 in the context of, and in preparation for, the change of the rule on inducements under MiFID II.

The FCA expects firms to unbundle the cost of research provided by client order executing brokers from the cost of order execution. Firms are required to establish the price of the research so received on an objectively justifiable basis. The FCA expects the firm to comply with the unbundling requirement, or explain why it does not comply with the same.

The FCA's policy aims in respect of the requirement to unbundle the cost of research and the cost of dealing are: (1) to improve firm controls regarding the purchase of research to ensure research bought in brings real value to client (where the cost of research is directly or indirectly passed on to client); (2) to improve the efficiency of the market for investment research, and specifically to enhance price transparency for investment research; and (3) to address the underlying conflict of interest resulting from the use of dealing commission to pay for external research, as the dealing commission is ultimately paid for by the client.

7.2 Changes under MiFID II

MiFID II will prevent portfolio managers from receiving any third party inducements, with a limited exception for "minor non-monetary benefits that are capable of enhancing the quality of service provided to a client and are of a scale and nature such that they could not be judged to impair compliance with the investment firm's duty to act in the best interest of the client".[73]

The European Securities and Markets Authority ("ESMA") has issued a consultation paper[74] which sets out an initial proposal for the detailed rules for MiFID II, which remain subject to change following feedback from stakeholders, including other regulators and industry bodies. Finalised detailed rules are expected to be implemented in early 2017.

ESMA's current proposal includes a discussion on the meaning of "minor non-monetary benefits" and recommends that the interpretation of the same should be narrowly construed.[75] Only very generic, widely-distributed financial research would qualify as a "minor non-monetary benefit".

By contrast, value-added research would not be a "minor" benefit and could not be received by a firm without a payment for the same. In the consultation paper ESMA explicitly stated that "any research that involves a third party allocating valuable resources to a specific portfolio manager would not constitute a minor non-monetary benefit and could be judged to impair compliance with the portfolio manager's duty to act in the client's best interest".[76]

ESMA's proposed rules are under discussion and remain subject to change at the current time. However, if ESMA's proposed incentive rules under MiFID II remain unchanged, it is likely that following the implementation of MiFID II and the secondary legislation thereunder, firms will not be permitted to pay for research received from brokers through the use of dealing commission, and will not be permitted to automatically pass the cost for the same to their client(s) as transaction costs. Firms will be required to absorb the cost of research provided by brokers, or fully disclose the cost of the research to their client(s) requesting the client to cover such costs, or increase its management fee to reflect the cost of research. This is a significant departure from the FCA's current rules on the use of dealing commission in COBS 11.6.

Firms could therefore be required to ensure that they do not receive any investment research (or other good or service other than minor non-monetary benefits) from brokers unless they specifically pay for it by January 2017 (upon the implementation of the detailed rules under MiFID II).

8. AIFMD

The Alternative Investment Fund Managers Directive ("AIFMD")[77] is a European directive which regulates the hedge, private equity and alternative investment fund industry in Europe and which came into force on July 22, 2012. The directive was part of a package of legislative measures introduced by the EU in response to the financial crisis. It was intended to address concerns regarding the level of understanding that investors had about the investments that they were making and the ability of regulators to identify the build-up of systemic risk in the alternative investment sector. It also sought to prevent the further occurrence of Madoff-style scams. It imposes organisational, management and systems requirements on alternative investment fund advisers that are either domiciled in the EU[78] or that manage investment funds domiciled in the EU ("AIFM"). It also imposes minimum standards of pre- and post-sale disclosure and regulatory reporting for non-EU managers that actively market their funds to EU investors (the "Minimum AIFMD Marketing Requirements").

The deadline for EU Member States to transpose the AIFMD into their national laws passed on July 22, 2013.

Whilst the large majority of EU Member States had transposed the AIFMD into their national laws by the July 22, 2013 deadline, several EU Member States (such as Finland, Italy, Norway and Spain) have been delayed in doing so.

In respect of the EU Member States which have transposed the AIFMD into their national laws, there is little conformity across these jurisdictions with regard to the requirements in a given EU Member State for non-EU investment advisers to market funds which they manage into the respective EU jurisdiction. Financial regulators in the majority of those jurisdictions have imposed marketing requirements that go beyond the Minimum AIFMD Marketing Requirements. Several EU Member States had provided for a one-year transitional period lasting until July 22, 2014, however, as this date has now passed, AIFMs are now required to comply with full set of AIFMD requirements as implemented in the relevant Member State.

In regard to implementation of the AIFMD requirements in the UK, now that the transitional period which had been provided in the UK has expired, a non-EU AIFM intending to market funds to investors domiciled or with a registered office in the UK would have to: (i) comply with the Minimum AIFMD Marketing Requirements; and (ii) provide prior written notification to the FCA in which the Non-EU AIFM confirms that the conditions of the Minimum AIFMD Marketing Requirements have been met. To the extent the UK investor is not a "Professional Investor",[79] the AIFM would additionally have to comply with the existing UK private placement regime.

8.1 Future developments: Marketing—passport for non-EU managers

Although AIFMD imposes a new onerous system of regulation on EU-domiciled managers, it does offer them one key advantage. An EU manager who is authorised pursuant to the AIFMD is able to market its European funds to professional investors throughout the EU on a "passported" basis; this means that, although it needs to comply with the AIFMD requirements, it does not need to concern itself with any additional obligations imposed by the EU jurisdictions in which it is marketing its fund.

However, such a passport is currently not available to non-EU managers (hence the requirement for non-European managers to comply with the individual placement regimes of each EU Member State in which marketing is intended to occur).

The AIFMD does provide a mechanism by which a non-EU manager may freely market non-EU funds to any professional investor domiciled in or with a registered office in the EU on a passported basis (this is known as the "Non-EU AIFM Marketing Passport"), though the non-EU manager must first obtain authorisation pursuant to the AIFMD. Such authorisation would be conditional upon the manager, at a minimum, appointing a local representative in the EU and being compliant with the full AIFMD requirements as applicable to EU managers (such as those relating to initial capital and own funds, staff remuneration policies, risk and liquidity management, organisational requirements, delegation restrictions, and appointment of a depositary for each fund under its management which it intends to market into the EU). However, such provisions in the AIFMD have yet to come into effect.

The non-EU AIFM Marketing Passport is expected to be made available in 2015 through the enactment of delegated regulation to the AIFMD, however, there has been no official confirmation from the relevant European regulators that they will be made available within this timeframe. The European Securities and

Markets Authority ("ESMA") is to provide advice on this subject to the European Parliament, the Council and the Commission prior to July 22, 2015, at which point those European bodies will decide whether to bring the provision containing the Non-EU AIFM Marketing Passport into effect.

It is additionally anticipated that, in July 2018, Member States will be required to prohibit any person who is not authorised pursuant to the AIFMD from marketing funds in their respective jurisdictions (i.e. private placement, which is currently allowed subject to compliance with the Minimum AIFMD Marketing Requirements, will be, in effect, turned off).

Anecdotally, some of the key regulators have been surprised at how few non-EU managers have expressed an interest in taking advantage of the non-EU passport and also at the number of large hedge fund managers who they expected to fall within the scope of the AIFMD as a result of their European presence, but whose EU offices have in fact turned out to be, or have been restructured as, sub-advisers rather than managers and therefore fall outside the scope of the Directive.

The authors will not be surprised if between now and 2018 there are moves to make the private placement and reverse solicitation regimes yet more restrictive with a view to shepherding recalcitrant managers into the scope of the Directive.

9. Revision of the Market Abuse Directive

Directive 2003/6/EC of the European Parliament and of the Council on Market Abuse ("MAD"), which came into force on April 12, 2003 has now been revised. In order to further promote harmonisation of market abuse and insider dealing regimes across the EU, the legislative replacement to MAD that was published in the Official Journal of the EU on June 12, 2014 was set out in the form of a draft regulation ("MAR") which shall be directly applicable in each of the European Member States without the need for national implementation when it comes into effect on July 3, 2016. Whilst MAR was developed alongside MiFID II, MAR comes into effect one year prior to MiFID II coming into effect on July 3, 2017. Consequently, those requirements in MAR which refer to concepts to be introduced by MiFID II (such as requirements applicable in relation to "OTFs") will not come into effect until July 3, 2017.

Accompanying the publication of MAR in the Official Journal of the EU, a directive was also published which introduces minimum rules on criminal offences and criminal sanctions for market abuse ("CSMAD"). The UK, however, has the right under the Treaty of Lisbon to opt into or out of any European legislative policy that relates to matters of justice and home affairs. The UK has exercised its discretion to opt out of CSMAD on the basis that the UK already has an established criminal market abuse regime.

Several of the major changes to be brought about by MAR are described below.

9.1 Financial Instruments traded on an MTF or OTF

In addition to financial instruments admitted to trading on a regulated market, the market abuse regime will be extended by MAR to capture financial instruments which are traded on an MTF as well as those traded on an OTF (being a new type of regulated trading venue to be introduced by MiFID II).[80]

Like regulated markets, MTFs and OTFs will also be required by MAR to adopt adequate structural arrangements to be able to detect and potentially prevent market abusive practices.[81]

9.2 Types of financial instruments captured by MAR

MAR will extend the offence of market manipulation to capture cross market manipulation conducted in relation to: (i) spot commodity contracts,[82] where the transaction, order, or behaviour has had, or is likely or intended to have, an effect on the price of financial instruments that are traded on a regulated market, MTF or OTF; (ii) other financial instruments (e.g. derivatives), where the transaction, order, bid, or behaviour has, or is likely to have, an effect on the price of related spot commodity contracts;[83] (iii) emission allowances and other products auctioned pursuant to the Emissions Trading Regulations;[84] and (iv) financial benchmarks.[85]

9.3 Intermediate steps

Reflecting the ruling by the European Court of Justice in the *Daimler* case,[86] MAR clarifies that information relating to an intermediate step which is part of a protracted process may be precise information and therefore can, by itself, constitute inside information provided all other criteria of inside information as set out in MAR are satisfied.[87]

9.4 Significant effect on price/reasonable investor test

MAR interprets information which, if it were made public, would be likely to have a significant effect on the prices of financial instruments to mean "information a reasonable investor would be likely to use as part of the basis of his investment decision".[88] This aligns with the Upper Tribunal's interpretation of "significant effect on price" in the UK case of *FSA v Massey*.[89]

9.5 Presumption of use

The recitals of MAR state that a person in possession of inside information who carries out any transaction related to that inside information shall be presumed to have used that information,[90] but this presumption may be rebutted if the person can establish that he did not use the inside information in carrying out the transaction. Whilst this presumption is not expressly set out in the main text of MAR,[91] the main text of MAR does refer to situations where a person in possession of inside information shall not, in itself, be "deemed" to have engaged in insider dealing (for example, where adequate and effective Chinese walls have been established). This aligns with the ruling by the European Court of Justice in the *Spector Photo* case.[92]

9.6 Attempted market abuse

MAR will extend the insider dealing and market manipulation offences to also include attempted abusive behaviour such as where a person attempts to commit insider dealing but the order is unsuccessful. It is, however, difficult to see how national regulators will be able to detect such attempted abusive behaviour in the absence of an actual effect on the markets.

9.7 Market soundings

One particular behaviour which MAR recognises as not constituting an improper disclosure of inside information is the performance of market soundings. In order to gauge the interest of potential investors in a possible transaction and the conditions relating to it (such as its potential size or pricing), issuers of financial instruments, secondary offerors of a financial instrument in such quantity or value that the transaction is distinct from ordinary trading, emission allowance market participants, and third party agents acting on behalf of, or on the account of, such persons will be required by MAR to specifically consider whether the market sounding will involve the disclosure of inside information.[93] The disclosing market participant will be required to make a written record of its conclusion and the reasons for that conclusion, both of which must be provided to a national regulator on request. MAR includes a presumption that a marketing sounding was made legitimately in the normal course of the exercise of a person's employment, profession or duty where, in addition to the requirements already mentioned if, before making the disclosure, the disclosing market participant:

- obtains the consent of the person receiving the market sounding to receive inside information;
- informs the person receiving the market sounding that he will be prohibited from using that information, or attempting to use that information, by acquiring or disposing of, for his own account or for the account of a third party, financial instruments relating to that information;
- informs the person receiving the market sounding that he will be prohibited from using that information, or attempting to use that information, by cancelling or amending an order which has already been placed concerning a financial instrument to which the information relates;
- informs the person receiving the market sounding that by agreeing to receive the information he is also agreeing to, and must, keep the information confidential;

and, after making the disclosure, the disclosing market participant:

- makes and maintains a record of all information given to the person receiving the market sounding, including the information given in accordance with the bullet points above, and the identity of the potential investors to whom the information has been disclosed, including but not limited to the legal persons and the natural persons acting on behalf of the potential investor, and the date and time of each disclosure.[94]

The disclosing market participant must also inform a person who has received a market sounding once the information ceases to comprise inside information and keep a record of such correspondence.[95] Although this is a useful clarification there is some doubt as to how this might work where firms involved in an offering of securities reach a different conclusion as to whether the information to be disclosed is inside information or not. In such situations some recipients of the information may find that they have agreed to restrict themselves from trading, whereas others have not. Further details are to be provided in secondary legislation to be drafted by ESMA.

9.8 Insider lists

Issuers of a financial instrument admitted to trading on a regulated market or traded on an MTF or OTF (with the exception of issuers whose financial instruments are admitted to trading on an SME growth market), emission allowance market participants, emission allowance auction platforms, auctioneers and auction monitors and any person acting on their behalf will be required to maintain, and keep updated, a list of employees (or otherwise those performing tasks for the issuer, e.g. advisers, accountants or credit rating agencies) who have access to inside information and to ensure that any person on the list acknowledges in writing the legal and regulatory duties entailed and is aware of the sanctions applicable to the misuse or improper disclosure of such information.[96] MAR will require the list to at least include the following:

- the identity of any person having access to inside information;
- the reason for including that person in the list;
- the date and time at which such person obtained access to inside information; and
- the date at which the insider list was created.

This list will need to be updated where:

- there is a change in the reason for including a person already on the insider list;
- there is a new person who has access to inside information and needs, therefore, to be added to the insider list; and
- a person ceases to have access to inside information,

with the time and date for the event which triggered the update recorded.

Further details are to be provided in secondary legislation to be drafted by ESMA.

9.9 Manager's transactions

Issuers of financial instruments admitted to trading on a regulated market, or traded on an MTF or OTF, and emission allowance market participants will be required to maintain a list of persons discharging managerial responsibilities within their company and persons closely associated with them.[97]

Such persons discharging managerial responsibilities will be required to notify to: (i) the issuer or emission allowance market participant; and (ii) the relevant national regulator, about the existence of every transaction (including the pledging and lending of financial instruments) conducted on their own account relating to the shares or debt instruments of that issuer, or to derivatives or other financial instruments linked to them, or in emission allowances, auction products, or related derivatives within three business days after the transaction once the total amount of such transactions by a particular individual has reached €5,000 within a calendar year (though national regulators have the discretion to increase this threshold to €20,000).[98] The issuer or emission allowance market participant will, in turn, be required to make such information public (unless national regulators implement alternative arrangements to make public such information themselves).

MAR will require the notification to include the following information:

- name of the person;
- reason for notification;
- name of the relevant issuer or emission allowance market participant;
- description and identity of the financial instrument;
- nature of the transaction(s) (e.g. acquisition or disposal);
- date and place of the transaction(s); and
- price and volume of the transaction(s) (in the case of a pledge whose terms provide for its value to change, this should be disclosed together with its value at the date of the pledge).

9.10 Investigatory and supervisory powers of national regulators

MAR will require Member States to designate a single regulator for the purposes of overseeing national compliance with the market abuse rules. In conformity with national law, MAR provides the relevant national regulator with wide ranging supervisory and investigatory powers, which include (but are not limited to) the powers to:

- have access to any document and other data (in any form);
- require or demand information from any person;
- in relation to commodity derivatives, request information from market participants on related spot markets according to standardised formats, obtain reports on transactions, and have direct access to traders' systems;
- carry out on-site inspections, or investigations at sites other than the private residences of national persons;
- enter premises of natural and legal persons in order to seize documents and other data, or require existing data traffic records from a telecommunications operator, where there is a reasonable suspicion that such document, data or record may be relevant to prove a case of insider dealing or market manipulation;
- refer matters for criminal investigation;
- require existing recordings of telephone conversations, electronic communications or data traffic records held by investment firms, credit institutions or financial institutions;
- require, insofar as permitted by national law, existing data traffic records held by a telecommunications operator, where there is a reasonable suspicion of an infringement and where such records may be relevant to the investigation of an infringement of MAR;
- request the freezing and/or sequestration of assets;
- suspend trading of the financial instrument concerned;
- require the temporary cessation of any practice considered contrary to the market abuse rules;
- impose a temporary prohibition on the exercise of professional activity; and
- take all necessary measures to ensure that the public is correctly informed, including the correction of false or misleading disclosed information, including by requiring an issuer or other person who has published or disseminated false or misleading information to publish a corrective statement.[99]

9.11 Administrative sanctions

One of the key criticisms of the existing market abuse regime has been the significant variation in sanctions seen across the EU. For the first time, MAR establishes a framework for civil sanctions for market abuse. Companies convicted of market abuse could be fined up to 15 per cent of their annual turnover or, if greater, €15 million. Individual perpetrators could face fines of up to €5 million and a temporary, or in some cases permanent, ban on doing certain jobs within investment firms.[100]

Notes

1. FCA Clive Adamson speech, July 18, 2013.
2. FCA Tracey McDermott speech, October 8, 2013.
3. FCA John Griffith Jones speech, November 13, 2014.
4. FCA John Griffith Jones speech , November 13, 2014.
5. FCA 2014/2015 Business Plan.
6. FCA Will Amos speech , September 24, 2014.
7. FCA Tracey McDermott speech, October 8, 2013.
8. FCA David Lawton speech, September 19, 2014.
9. FCA Will Amos speech, September 24, 2014.
10. FCA Will Amos speech, September 24, 2014.
11. FCA Martin Wheatley speech, November 14, 2014.
12. "Economics, technology and data—redefining the future of conduct regulation." (Martin Wheatley, November 14, 2014).
13. In three parts. Parts 1 and 2 have been published. Part 3 is underway at the time of writing.
14. Thematic Review: "Supervising retail investment advice: how firms are implementing the RDR" July 2013 [TR13/5] ("Thematic Review 1").
15. Thematic Review: "Supervising retail investment advice: Delivering independent advice" March 2014 [TR14/5]. ("Thematic Review 2a").
16. Thematic Review: "Supervising retail investment firms: Being clear about adviser charges and services" April 2014 [TR14/6]. ("Thematic Review 2b").
17. P.6 Thematic Review 2a.
18. P.3 Thematic Review 1.
19. P.6 Thematic Review 2a. This review gave the example of self-invested pension plans ("SIPP"). If a SIPP was suitable for a particular client, an adviser should research the SIPP market, then carry out due diligence on the specific SIPP product.
20. P.8 Thematic Review 2a.
21. P.4 Thematic Review 2b.
22. FCA Factsheet 007: "Disclosing your firms charges and services."
23. FCA website page relating to Thematic Review 2b (http://www.fca.org.uk/news/thematic-reviews/tr14-6-supervising-retail-investment-firms).
24. FCA John Griffith Jones speech, November 18, 2014.
25. P.8 Thematic Review 2b.
26. Consultation Paper: "Strengthening Accountability in Banking: a new regulatory framework for individuals" July 2014 [CP14/13].
27. Financial Services (Banking Reform) Act 2013.

28. Parliamentary Commission on Banking Standards:"Changing banking for good", House of Lords, House of Commons [HL Paper 27-1].

29. FCA Press Release: "Prudential Regulation Authority and Financial Conduct Authority consult on proposals to improve responsibility and accountability in the banking sector", July 30, 2014.

30. Code of Practice and Principles for Approved Persons ("APER").

31. APER will continue to apply to firms not designated as "relevant firms".

32. Consultation Paper para.7.36.

33. Consultation Paper para.5.13.

34. Discounted for early settlement.

35. January 22, 2014, Final Notice.

36. FCA Press Release: "Standard Bank PLC fined £7.6m for failures in its anti-money laundering controls", January 23, 2014.

37. Discounted for early settlement.

38. FCA Press Release: "State Street UK fined £22.9m by Financial Conduct Authority for Transition Management failings", January 31, 2014.

39. FCA Press Release: "HomeServe fined £30 million for widespread failings", February 13, 2014

40. Breach of Principle 6.

41. FXCM Securities received a public censure for breaches of Principle 6 and rules relating to best execution.

42. FCA Press Release: "The Financial Conduct Authority fines FXCM UK £4 million for making 'unfair profits' and not being open with the FCA", February 26, 2014.

43. And breaches of the associated conduct of business rules.

44. FCA Press Release: "Santander UK fined £12.4 for widespread investment advice failings", March 26, 2014.

45. Breach of Principle 7.

46. Breach of Principle 3.

47. FCA Press Release: "Invesco Perpetual fined £18.6 million for failings in fund management", April 28, 2014.

48. In breach of APER 1.

49. Reduced from the FCA's initial penalty in the decision notice of £3,000,000.

50. *Alberto Micalizzi v The Financial Conduct Authority* [2014] UKUT 0335 (TCC) at [468].

51. FCA Press Release: "Barclays fined £26 million for failings surrounding the London Gold Fixing and former Barclays trader banned and fined for inappropriate conduct", May 23, 2014.

52. FCA Press Release: "Lloyds Banking Group fined £105m for serious LIBOR and other benchmark failings", July 28, 2014.

53. FCA Press Release: "FCA fines five banks £1.1 billion for FX failings and announces industry-wide remediation programme", November 12, 2014.

54. Breach of Principles 3 and 10.

55. FCA Press Release: "Barclays fined £38 million for putting £16.5 billion of client assets at risk", September 23, 2014.

56. *Ian Charles Hannam and the Financial Conduct Authority* [2014] UKUT 0233 (TCC).

57. FSMA s.1182(C) defines inside information as information that is of a precise nature, not generally available, that relates to issuers of qualifying investments or qualifying investments and that, if generally available, would be likely to have a significant effect on the price of the qualifying investments.
58. FSMA s.123(2)(a).
59. FCA Press Release: "FCA publishes Final Notice for Ian Hannam and confirms a financial penalty of £450,000", July 22, 2014.
60. Discounted for early settlement.
61. FSMA s.118(1) and (5).
62. FCA Press Release: "FCA bans and fines trader £662,700 for manipulating gilt price during QE", March 20, 2014.
63. FSMA ss.393(4) and s.393(9) (A person to whom a copy of the notice is given under this section may refer to the Tribunal the decision in question so far as it is based on a reason of a kind mentioned in s.393(4) or any opinion expressed by the regulator in relation to him.)
64. *Achilles Macris v The Financial Conduct Authority* [FS/2013/0010] at [55].
65. EU Directive 2014/65.
66. EU Regulation 600/2014.
67. COBS 2.3.1R provides that a firm must not pay or accept any fee or commission, or provide or receive any non-monetary benefit , in relation to investment business carried on for a client, other than a fee, commission or non-monetary benefit paid or provided to or by the client (or a person on behalf of the client); or, provided to or by a third party (or a person acting on behalf of a third party) if the payment of the fee or commission does not impair compliance with the firm's duty to act in the best interests of the client and has been first disclosed to the client.
68. Namely warrants, certificates representing certain securities, options or rights to or interests in such investments, to the extent that they relate to shares.
69. COBS 11.6.3R
70. The FCA will generally consider that a good or service directly relates to the execution of trades on behalf of the investment manager's clients if it is: (a) linked to the arranging and conclusion of a specific investment transaction or series of related transactions; and (b) provided between the point at which the investment/trading decision is made and the point at which the transaction (or series of transactions) is concluded.
71. COBS 11.6.3R(3)
72. COBS 11.6.8A(2)G
73. MiFID II, Level 1, art.24(8).
74. ESMA Consultation Paper: MiFID II /MiFIR
75. ESMA Consultation Paper: MiFID II /MiFIR, s.2.15, pp.118–125.
76. ESMA Consultation Paper: MiFID II /MiFIR, s.2.15, para.14.
77. EU Directive 2011/61/EU.
78. References to the "EU" include both the 28 Member States of the "European Union" plus Iceland, Liechtenstein and Norway, as the AIFMD is applicable in those countries also.
79. AIFMD art.4(l)(ag).
80. MAR art.2(1).
81. MAR art.16.

82. MAR art.2(2)(a).
83. MAR art.2(2)(b).
84. MAR art.2(l).
85. MAR art.2(2)(c).
86. *Markus Geltl v Daimler AG*, C-19/11.
87. MAR art.7(3).
88. MAR art.7(4).
89. *Financial Services Authority v Massey* [2011] UKUT 49 (TCC).
90. MAR recital 24.
91. MAR art.9.
92. *Spector Photo Group NV v Commissie voor het Bank, Financie-en Assurantiewezen*, C-45/08.
93. MAR art.11.
94. MAR art.11 (5)
95. MAR art.11 (6).
96. MAR art.18.
97. MAR art.19(5).
98. MAR art.19(1).
99. MAR art.23.
100. MAR art.30.

Issue 123—Financial Crime Update

Authors: Baker & McKenzie's Cross-Border Financial Services Investigations and Enforcement practice

Topics covered will include:

- Overview of FCA Thematic Reviews on AML and Sanctions controls in small banks and the FCA Thematic Review of Bribery Risks in Commercial Insurance.
- Changes to the FCA Financial Crime Guide.
- Update on financial sanctions.
- The de-risking agenda.
- US enforcement tends: The DOJ and SEC.
- The Market Abuse Directive and its implications in the UK.
- Update on the Fourth Money Laundering Directive.

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